

**CITY OF LINCOLN
POLICE & FIRE PENSION ADVISORY MEETING
THURSDAY, FEBRUARY 1, 2001**

Members Present: Aaron Drake, Mark Meyerson, Jim George, Ross Hecht, Mark Westphalen,
and Joe Yindrick.

Members Absent: None

City Staff Present: Paul Lutomski, and Georgia Glass (joins meeting already in session)

Aaron Drake calls the meeting to order at 3:07 p.m.

Aaron Drake: Paul, will you give us a summary of recent activities?

Paul Lutomski: Item A, found on pages 1 through 6, is a synopsis of the minutes of the August and November meetings. I give them to you, so you can read them and vote to approve or amend them in May.

Item B, found on pages 7 and 8, is a copy of a letter that we sent out to all Plan B and C members on October 4th, 2000. The letter informed them of their opportunity to change to Plan A and of the implementation of the DROP when the IRS approves it. The letter included an individualized switch cost estimate and comparisons of their benefits under their current plan and also if they switch to Plan A.

Item C on pages 9 to 11 is a letter that was sent to all members on November 9th comparing the benefits in their current plan with and without utilizing the DROP plan.

Item D on pages 12 to 13, just wanted to let you know that the Vanguard Group of mutual funds offered a new class of funds with lower expense ratios called AAdmiral shares.≡ There is a list in your packet showing what the old expense ratio was and the new expense ratio is. We switched over all the applicable funds indicated on that list, and expect to have annual savings of at least \$5,748.00.

Item E on pages 14 –15 is a copy of a memo sent to the Budget Department on

November 22nd of 2000. The memo requested the City contribution be increased from the current level of \$944,000 to an amount calculated by multiplying the minimum actuarial rate times the valuation payroll.. Just received the actuary report at 2:30 this afternoon stating valuation payroll is \$29,400,000.00. Having a minimum rate of 9.2% of payroll translates into a requested City contribution of \$2.7 million. So, as you can see, we're asking for another 1.8 million dollars.

Item F, on December 5, 2000 Fire Apparatus Operator Dan Harlan awarded a duty disability pension. I'm sorry to report the Disability Review Committee initially denied Mr. Harlan's duty disability application. After speaking to Mr. Harlan and his attorney the committee changed their recommendation and granted the duty disability.

Jim George: The union is concerned about either the process or the people that make this decision.

Paul Lutomski: The process was developed probably seven years ago. The people that make the decision are the X actually they make a recommendation, but those folks are the Finance Director, the Health Department Director, and the Mental Health Administrator.

Jim George: I know that Dan had to spend his own money to get his attorney to come to the pension X or the disability review committee meeting. I don't see any reason to put him through this kind of thing. I think maybe something needs to be changed.

Paul Lutomski: Well, we discussed this with the Mayor and he said he didn't want to change the composition of the committee, or how the committee operated, but if you would like to bring this up in your Mayor's Task Force meeting, that might be a good place to get some input from other members.

Item G on our Agenda is just a note that December 6th 2000, attorney Jane Burke called, stating that Police Union wanted to change two things regarding the switch and the DROP. The first was the way a member pays back the pension if the elect to switch to Plan A. She said the Police Union wanted a periodic payment plan during active employment or a reduced monthly pension after retirement. I discussed these issues with John Cripe and Georgia Glass and Don Taute previously, therefore on the telephone at that time I told her ANo," because these methods would be more costly and complex to administer, and because the City Council approved the switch with the understanding the cost would be repaid in a lump sum at the time of change to

Plan A, and because Lincoln Municipal Code prohibits the City from being a creditor. In other words, the City can't loan people money. I added that the City already compromised on this issue by not charging interest on the contributions, and that any payment plan, if that should get changed in the future, should rightfully include interest to be fair to those members who paid their lump sum upfront.

The second thing she wanted changed regarded the one year DROP entry window for Plan B and C members. She wants B and C members to be able to enter the DROP at any future date, like Plan A members so that they can maximize their benefit percent. I told her ANo≡ on this issue also, because this committee, the City Council and Mayor Wesely had already discussed that. It was a costing issue that was taken to the City Council. It=s less expensive to have a one year window rather than allow the B and C members to maximize their pension percentage. The only way that this change could be affected would be to get a new actuarial cost for it, to persuade the Mayor and the City Council to vote Ayes≡, and then to reapply with the IRS for a new determination letter.

Paul Lutomski: Item H is the notice to you about the Police and Fire Pension DROP vendor selection committee. The members were Georgia Glass, mark Bowen, Don Herz, Police Sergeant Mark Meyerson, and Fire Captain Jim George. The members voted unanimously to select Smith Hayes. The education plan is for Smith Hayes to produce a video tape for Plan A members and a video tape for Plan B members. Both tapes will explain DROP and investing basics, and the Plan B tape will also discuss switching to Plan A and the opportunity for a Plan B member to deposit their pension plan account value into their DROP account. The videos will then be distributed to each Fire station and each Police station. The video will also be on the City Internet site as a Video on Demand. Live Presentations will be scheduled in the City Council Chambers. Two presentations for the Plan A members and two for the Plan B, C members. Tentative dates for the presentations will be in early March.

In a couple weeks, I hope to get together with Smith Hayes again and ask will ask Jim George to sit in on that discussion to just talk to them about education and ways to compare switching and dropping versus not switching and not dropping.

Item I, pages 16 through 20, is the copy of the annual letter that we sent out early in January, pension statements for each individual person, and then the normal age and service pension benefit estimate. There=s a table in the middle of page 16 showing the active member count, how that has changed from >96

through 2000. In 1998 we had 590 active members. In 1999 that went down to 545. In 2000, we ended the year with 565 members. Retired Pension member count has been steadily increasing. Currently it's at 300 members. Regular pension benefits also have been steadily increasing by about \$300,000 a year and we're currently at \$4 million yearly. On the next page, I like to draw your attention to a chart of monthly returns. You can see that from month to month the returns vary. Some being large positives, small positives and large negative amounts every month. We put this chart in to help members understand that their market values are fluctuating every month. We earned 11.13% this year for pretty much exactly the opposite reasons that we lost money last year, and that has to do with the Treasury yield curve. Interest rates as a whole decreased over the year 2000, and when interest rates decrease, the value of our bonds increase. Ending the year 2000, bonds returned 17.2%. Equities returned a negative 10%. However, only 23.2% of our assets were invested in equities, so the average portfolio return then was 11.13%.

Paul Lutomski: Item J is that on January 18th Police Officer Alvin Banks applied for a duty disability pension. So we'll see how the Committee treats this one.

Item K regards my idea that I was so happy about at the Mayor's Task Force Meeting, which looks like it might go nowhere, though. The Lincoln Municipal Code gives the Police and Fire Pension the authority to tax specific for the Pension separate from other taxes. I spoke to the Budget Office and City Attorney. They both said that the Pension falls under the lid, because the State of Nebraska legislation overrides anything in the Lincoln Municipal Code. If the Pension collected taxes separately, the total of the Pension's tax and the City's general tax would have to be combined and that total fall under the lid. I then asked Georgia if we could ask the Mayor to use the City lobbyist to try to get the State legislature to exempt the Pension tax from the lid. She said Yes. However, our Law Department says the chances the legislature exempting the pension tax from the lid are slim to none, because pension is considered a part of total compensation, and the idea behind the lid is to restrict spending growth which includes total compensation. If they exempted the Pension, there isn't any reason that they shouldn't exempt the civilian pension and the health insurance costs too.

Aaron Drake: But first class cities are forced to contribute a matching amount of employee contributions to the pensions for their Police Officers and Firefighters. Are they exempted from the lids, since the State forces them to contribute this amount?

Paul Lutomski: I don't know. That's a good question to look into, and I will do that. If they are exempted, that might help our case a little bit.

Aaron Drake: I don't know if you can share this information with us, but we would be interested in knowing the dollars contributed to the City's civilian pension and the dollars contributed to Social Security and the number of members in the City pension.

Paul Lutomski: I will ask and then get back to you with an answer on that. Item L is page 21 through 24. This is a preview of the summary annual report provided by the actuaries, and there's also two pages from the full report, which I passed out just before the meeting got started. The important bits of information are that the actuary report stated pre-funded future normal costs, in other words the over-funding, decreased from \$9.2 million to \$5.7 million. This occurred even though the assets earned 9.42%, which is more than the 7.5% assumption rate. What caused it to occur was because the Police Union average wage increase was 10.23% and the actuarial assumption wage increase assumption is 5%. The increased wages cost more than the gain by beating the interest rate assumption. The other piece of information is that the minimum recommended rate, which is based on amortizing the pre-funding over a ten year period, increased from 7.29% last year to 9.2% this year. You will remember the 9.2% times \$29 million valuation payroll gets us to our recommended City contribution of \$2.7 million.

The next few things are just for your information. But I wanted to mention these three. Item M on page 25 is an article in *Pensions and Investments* magazine that said if you're assuming a 7 2% interest rate such as we are, that would go well with a 30% equity, 70% debt allocation, so we're right on target with what the industry is expecting. We also are going to ask you later to approve a 50% equity allocation and this article mentions that a 50% equity, 50% debt allocation could justify an interest rate assumption of 9%. However, they also caution that you should not use that assumption rate until you get to the 50 B 50 equity B debt allocation.

Item N on page 26. John Cripe wanted me to put this in to show that New York City pension funds returned 9.48% in fiscal year 2000. We returned 9.42%. I don't know what New York's fiscal year ends. We returned 11.13% for the calendar year, but nonetheless it doesn't compare too bad to New York's return.

Item O on page 27 through 29, a copy of a *Money Magazine* article wherein American Funds is shown to compare favorably to industry averages regarding expenses and returns.

Item P on pages 30 through 32 are the security transactions from October 31st through December 31st of 2000. There isn't anything real interesting in those. It's just the standard items of selling treasury strips and purchasing equities every month. Pages 33 and 34 show assets grouped by classes, as of December 31st of 2000. The pension has 76% of its money in debt, and 23 2% in equity. These pages, in fact, show every single individual investment we have listed separately, so you can see where the money is. The pension has only \$2 million in bonds and notes that pay coupon rates. A Tennessee Valley Authority Bond. We have \$54 million in CMO=s. All of those pay coupons every month that we need to make our monthly benefit payments. We have \$41 million in zero coupon bonds. Both treasury strips and agency zeros, and then the individual stock funds that we own are down below that. We break them apart into style categories. Domestic large cap blend. Domestic large cap growth. Domestic large cap value. Mid cap, small cap, international, growth, value, etc. Pages 35 through 39 are numbers and graphs with more return data. Page 35 is the big picture that we already mentioned for calendar year 2000. Equities down 10%, debt up 17 2%. Total is 11.13% and then it shows two, three and five year annualized returns. Page 36 is a risk adjusted return for our equities. We=re using the alpha and beta calculated off of the S&P 500 index over the last 5 years. Essentially what it shows is that we are, for the risk that we=re taking, we=re getting a better return than expected. In other words, our managers are doing a good job minimizing the risk and maximizing the returns. Page 37 shows the debt portfolio asset class returns. Agency and treasury coupon bonds returned 16.9%. Class, the next class over, treasury and agency zeros, 22 2%. Treasury and agency CMO=s returned 14.63%, and there is also 2-, 3- and 5-year returns for those same asset classes. Page 38 has the numbers you=ve already seen before, but puts them in an ordinal ranking from greatest to least, and also adds the valuation percentage. For example, the zeros from governments returned 22.54% and contained 24% of total assets.. The Vanguard Group X I want to mention Vanguard and American Funds performance specifically. Vanguard, which is our indexed manager, a passive manager, they lost 11.3% last year and they=re about 12 2% of our total asset evaluation. American Funds, the active manager, lost 8 2%. Pretty much did 3% better, but they=re about 11% of assets. What that says is we have more money in passive and the passive did not perform as well as the active, so keep that in mind, because I=m going to ask that we don't put any more money in passive later. And on page 39, it shows a more detailed breakdown of the equity. It shows every equity we have. Calendar year returns as well as 2- to 3- to 5-year returns. Page 40 is the balance sheet. We have \$131 million market value assets altogether. At the bottom there, you can see we=re in violation of the investment policy, but that=s okay, because the committee allowed us to do that during this time period when we=re accumulating equity

assets up to 30% of value. Page 41 shows sources and uses for the calendar year. We have employee contributions at \$1.4 million and the City put in \$960,000. We have the interest coming in at \$3.6 million, which we'll need to talk about later. We realized gains when we sold treasury strips and reinvested them into both CMOs and equities. \$7 million. Unrealized gains of \$2 million.

That means we haven't sold those issues yet. As I said before, retirement benefits are recorded as uses of funds. We paid out \$4 million if you add all the monthly numbers up. The lump sum trustee transfers and direct payouts for employees came to a little bit over a million dollars. Then there is a breakdown of all of the smaller expenses, like printing, advertising, and rent on my office.

Which brings me to the new business section. The investment policy recommended changes. The whole policy is listed on pages 42 through 47. The policy right now says we can at most 30% of our assets into equities. I'd like to make the changes as shown on page 44 with the strikeouts and underlined. The changes would get it so debt securities must be at least 50% of assets, rather than 70%, meaning equities could be the other 50%. I would like the restriction of 90% of those debt securities being guaranteed by the treasury to be reduced to 50%, because we can get a little bit of a yield pickup on Ginnie Mae backed securities over treasuries, and Item 3 wouldn't change. That means that the other 50% of debt assets not backed by the treasury for principal and interests payments are specified here as federal home-loan mortgage corporation, federal home-loan bank, fannie mae, sally mae and corporate securities. Corporate securities' safety-issue is addressed on page 42, where it says that corporates have to be rated A1. I don't see the pension owing corporates in the near future.

Mark Westphalen: Would you consider corporate securities if they are insured?

Paul Lutomski: That depends what the insurance covers.

Mark Westphalen: It'll cover timely principal and interest payments and I know Edward Jones just issued, or underwrote an issue for \$40 million.

Paul Lutomski: We should get together, Mark, and talk about that some more. I'd like some more information on that. It sounds interesting. I probably would want to hire a manager, though, if we invest in corporates, because of the due diligence requirements. That would take up a lot of my time and I think a manager would be better suited for that than I would. Okay, Item 4 on the changes is that I want to just get rid of the restriction on mortgage backed securities. Right now it says they can't exceed 30% of debt securities. As we'll talk later, if we get to this 50% equity exposure, we're going to need a lot of our debt working for

us in order to pay our monthly benefits and mortgage backed securities will offer us a yield pickup over treasury bonds and notes, and they will also pay us interest every month on the 15th or 20th that we turn around and pay out in just a couple days after that. Treasuries will pay 1 to 2% less than mortgage backs and they only pay every quarter, so we would have to keep that money in a bank repo pool, rather than just turn around and pay it out. We earn less money in a repo pool than we would on the baseline investment. Are there any questions? Or do you want to argue with me about changing the investment policy?

Jim George: I make a motion to approve the changes to the investment policy as indicated on page 44.

Mark Meyerson: Second.

Aaron Drake: All in favor? (All ayes)

Paul Lutomski: Okay that was easy. New Business Item B is that I would like to change the equity investment plan for actively managed securities and then also increase the monthly amount invested from \$909,000 to \$1.2 million. Originally the target mix was 65% passive and 35% active. We changed toward more actively managed equities in February 2000, which was our 6 month balancing point. We changed that target to 50% passive and 50% active, because we expected the equity market to become more selective. Things were getting thin. When the S&P or Dow was showing a 10% increase, it wasn't that the entire market went up 10%. It was because the top few stocks went up 20 or 30% and the rest just sat there or went down, possibly up a little bit. So, we wanted to get more of the active then. Active managers have more flexibility to select stocks with higher potential returns when the market gets thin like that. And, in fact, during calendar year 2000, it showed, as I said, that actively managed American Funds lost 3% less money than passively managed Vanguard Funds. This trend is expected to continue, as Mark Westphalen said in the Mayor=s Task Force meeting. So I=d like to have a new target be 40% passive and 60% active. Now regarding the increase in the monthly investment from \$909,000 to \$1.2 million, this is not accelerating the current amount. It=s just readjusting the amount to attain the original 30% target on August 31st of 2001. The amount needs to be readjusted because equities lost money in 2000 and our bonds did better than we expected. So, per the current plan, we want to sell zero coupon bonds to fund our equity purchases. To get to the 30% using current market values, we need to invest \$82 million. We=ve got seven months, so that means \$1.2 million dollars a month. I made a new spreadsheet to show how I recommend the funds be invested, and that spreadsheet is on

page 48. Essentially, we're using the same funds as before, just bumping up the amount proportionately to \$1.2 million. You can see now, if things hold, we'll be 61% domestic, 39% international; 42% indexed, 58% active; value at 53%, growth 47%. Then pretty much half of the money is in large cap and the rest is split equally between mid cap and stocks. If there are any questions on this, we can discuss this, or the committee can vote to approve it.

Aaron Drake: I will make a motion to approve the new equity investment plan.

Jim George: Second.

Aaron Drake: All in favor?

Everyone says Aye@

Paul Lutomski: Okay. Finally, Item C on New Business. It's how do we get to this 50% equity allocation. I have some issues that need to be addressed. Basically the issues are that we want to make sure we have enough money to pay our monthly pension benefits while we are accumulating equities and we want to have a final equity percentage that will allow us to continue to pay those monthly pension benefits without having to sell the principal of the equity or the debt investments. If the City puts in exactly the same amount of money as it does now, five years after attaining the 50% equity allocation, we will need to sell principal of either debt or equity to make our monthly pension payments. If the City puts in more money, depending on how much more, we shouldn't have a problem in that regard. Please take a moment to read rough page and a half plan that I've put together. *(Everyone reads the plan.)*

So to summarize I recommend to continue to invest the \$1.2 million each month into equities while seeking a higher City contribution to the Pension plan. I want to sell zero coupon bonds to fund the equity investment, and then monitor cash flow needs, sell more bonds to buy monthly interest paying CMO's that have Ginny Mae collateral as needed.

Mark Westphalen: I'm concerned about selling the zero coupon bonds in a down interest rate environment. As you said, when interest rates go down, the value of bonds goes up. The longer zeros will appreciate more in value than the shorter maturity zeros.

Paul Lutomski: Yes, I'm aware of that, and actually my more detailed plan is to start by selling an agency zero that has a call date in March of 2001. The call strike price is about 21 2. I got a collar on it at 19 1/4 last week, so I'm thinking that should be the

first one to sell. Going back to page 33 you can see that the other agency zeros begin their call ability in April and May respectively, and then we also have \$2 million of a TVA to pay the quarterly coupons, selling all that, which should provide us at least with the six months, \$8 2 million that we need. After that, we=ll have no choice but to sell the treasury strips, since that=s all that remains of the debt assets other than the CMO=s we need for monthly payments. I will sell the shortest maturity treasury strip in order to fund the equity purchases. In bold, at the last part of my recommendation, I want to make it very clear that there is more market price risk with CMOs than with Treasury bonds even though both have the treasury full faith guarantee for timely principle and interest payments. CMO=s with Ginny Mae collateral generally provide one to two percent higher coupon interest than a comparable duration treasury bond. As long as spreads to treasuries remain stable, the CMO market value will be as stable as the treasury bond market value. We need to invest in these issues because we are seeking higher coupon rates because the City doesn=t want X or isn=t able to increase their contribution to the Pension. However, I want to make sure everyone knows that if the spreads to treasuries widen, as interest rates move then CMO=s won=t perform as well as the comparable duration treasury, but it seems a risk that we need to take based upon the return figures that we need to have. If the City increases their contribution to full minimum recommended levels, then maybe we can ease up on this and buy treasury bonds instead. I=m done. Does anybody else have any new business?

Aaron Drake: Yes, I have a new business item.

(Georgia Glass enters the meeting at this point)

Aaron Drake: Last year myself and Jim George attended the NCPERS conference in Hawaii. The cost to attend the conference was paid by the Fire Union. It was a very educational and informative conference, and we took the knowledge gained there and brought it back to this committee. It helped us to develop a better DROP plan, I believe, than we would have been able to develop had we not gone to the conference. The Mayor has a Pension Task Force wherein he is talking about allowing us to give recommendations to change the government structure, perhaps into a trustee, a board of trustees, rather than an advisory committee. I would like to make a motion that the pension plan pay for the cost of sending the advisory committee members to the NCPERS conference occurring in Las Vegas this year, April 8th through 12th. Last year, we asked, at very short notice, and were told that the City would not pay. I believe our time off was paid by the Department, but the Fire Union paid the cost to attend the conference.

Paul Lutomski: Well, maybe we can find out what this would cost, and then Georgia could get back to me with an answer for you.

Georgia Glass: Aaron, how many people were you thinking of going? If it was all the committee members that might be too much. Perhaps one committee member could go.

Aaron Drake: It would be beneficial if all members went. That way they could get first hand knowledge of the information at the committee.

Paul Lutomski: Well, let's get some prices together and then Georgia can get back to me, and then I'll communicate that to you, Aaron.

(Georgia Glass leaves the room.)

Aaron Drake: Any other new business?

Jim George: Yes. I'd like to make a motion regarding amending the DROP ordinance. The reason is that Fire and possibly Police members are expecting talks to begin regarding pension enhancements. This means there is the possibility that pension enhancement talks and implementing the DROP plan could be taking place concurrently. I know that members are hesitant to enter the DROP, because once in the DROP they will not be able to receive any future pension enhancements.

I understand that normally when a person enters the DROP, if pension enhancements occur the person doesn't get to exit the DROP plan to take advantage of those enhancements. But this is an unusual situation when we're talking about both of these issues at the same time.

I make a motion that Georgia speak to the City Council and recommend that the Council amend the DROP ordinance so that for one year after any pension enhancements are implemented a member in the DROP plan may opt out of the DROP forfeiting their DROP assets to the Pension and reverting to the enhanced pension plan.

Mark Westphalen: I second that motion.

Aaron Drake: All in favor?

(Everyone says Aaye@)

MEETING ADJOURNED AT 5:05 P.M.

